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IN THE

Supreme Court of the United States

October Term, 1979

No. 79-1785

NORTHERN NATURAL GAS COMPANY,
Petitioner

v.

PREMIER RESOURCES, LTD.

PETITION FOR WRIT OF CERTIORARI TO UNITED STATES COURT OF APPEALS, TENTH CIRCUIT

3/4/81

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INDEX

	Page
Opinions Below	1
Jurisdiction	2
Questions Presented	2
Administrative Order Involved	2
Statement of Case	3
Reasons for Granting Writ	11
Conclusion	14
Certificate of Service	15

Appendix A

Opinion of the United States Court of Appeals, Tenth Circuit of March 4, 1980	A-1
Opinion No. 742 of the Federal Power Commission issued on August 28, 1975	A-23
Recall of Mandate of March 26, 1980 of the United States Court of Appeals, Tenth Circuit, issued on April 18, 1980	A-48
Opinion of the Honorable Luther B. Eubanks, United States District Judge for the Western District of Oklahoma, of November 17, 1978 in Premier Resources, Ltd. vs. Northern Natural Gas Company	A-49

TABLE OF CASES

	Page
F.P.C. v. Texaco, Inc., 417 U.S. 380 (1974)	2, 4, 5, 6, 7, 8, 11, 13
Layne & Bowler Corp. v. Western Well Works, Inc., 261 U.S. 387 (1923)	11
NLRB v. International Van Lines, 409 U.S. 48 (1972)	11
Texaco v. F.P.C., 474 F. 2d 416 (1972)	4, 5, 8
United States v. Constantine, 296 U.S. 287 (1935)	13

STATUTES

14 U.S.C., Sections 717 et seq., the National Gas Act	12
28 U.S.C., Section 1254 (1)	2
28 U.S.C., Sections 1332 (a) and (c)	3
28 U.S.C., Section 2201	3

MISCELLANEOUS

18 Code of Federal Regulations, Section 154.93 (b-1)	6
Federal Power Commission Opinion No. 742, 54 FPC 853, August 28, 1975	2, 4, 5, 8, 9, 10, 11
Federal Power Commission Opinion No. 742-A, 56 FPC____, July 27, 1976	2, 5, 8
Federal Power Commission Opinion No. 770, 56 FPC____, July 27, 1976	8
Federal Power Commission Order No. 428, 45 FPC 454, March 18, 1971	2, 3, 4, 5, 6, 7, 8, 9, 11, 12, 13
Rules of the Supreme Court of the United States, Rule No. 19	13

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No. .....

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v.

PREMIER RESOURCES, LTD.

PETITION FOR A WRIT OF CERTIORARI TO THE UNITED STATES COURT OF APPEALS, TENTH CIRCUIT

To the Honorable, the Chief Justice and Associate Justices of the Supreme Court of the United States:

Northern Natural Gas Company (now named Inter-North, Inc.), the petitioner herein, prays that a writ of certiorari issue to review the judgment of the United States Court of Appeals, Tenth Circuit entered in the above-entitled case on March 4, 1980.

OPINIONS BELOW

The opinion of the United States Court of Appeals, Tenth Circuit is unreported and is printed in Appendix A hereto, infra, page A-1. On April 18, 1980 the Court of Appeals ordered that the mandate of such court which issued March 26, 1980 be recalled and stayed

until May 8, 1980, pending certiorari, a copy of which order of April 18, 1980 is printed in Appendix A hereto, infra, page A-48.

The Opinion of the United States District Court for the Western District of Oklahoma, United States District Judge Luther B. Eubanks presiding, is printed in Appendix A hereto, infra, page A-49.

JURISDICTION

The judgment of the United States Court of Appeals, Tenth Circuit (Appendix A, infra, page A-1) was entered on March 4, 1980. The jurisdiction of the Supreme Court is invoked under 28 U.S.C. Section 1254(1), 62 Stat. 928.

QUESTIONS PRESENTED

Did either the Supreme Court, in *F.P.C.* v. *Texaco*, 417 U.S. 380 (1974), or the Federal Power Commission, in its subsequent adoption of its Opinion No. 742, vacate the Federal Power Commission's previously adopted Order No. 428 or make it not effective with respect to the sale price for natural gas sold in interstate commerce by small producers pursuant to agreements executed during the period from the adoption of Order No. 428 until the subsequent adoption of Opinions No. 742 and 742-A?

ADMINISTRATIVE ORDER INVOLVED

This case involves Federal Power Commission Opinion No. 742, the text of which is printed in Appendix A hereto, infra, page A-23.

STATEMENT OF CASE

The court of first instance in which this case was filed is the United States District Court for the Western District of Oklahoma. The basis for federal jurisdiction is the diversity of citizenship of the parties and is based upon 28 U.S.C., Sections 1332(a) and 1332(c). The action was brought for declaratory judgment pursuant to 28 U.S.C. 2201.

After a trial without a jury, the trial judge announced he was entering judgment for the defendant. The trial judge's opinion was dictated into the record immediately upon conclusion of oral argument.

The plaintiff in the court of first instance appealed the case to the United States Court of Appeals, Tenth Circuit. The Court of Appeals reversed the decision of the trial judge. A review of such reversal is sought by this Petition.

The plaintiff in the court of first instance, and the respondent herein, is a "small producer" of natural gas. The defendant in the court of first instance and the petitioner herein, is an interstate natural gas pipeline company which purchases natural gas. A "small producer" has been defined by the Federal Power Commission ("the Commission") as an independent producer, not affiliated with a natural gas pipeline company and whose total jurisdictional sales on a nationwide basis, together with sales of affiliated producers, did not exceed 10 billion cubic feet at 14.65 psia during any calendar year.

For background, the Court will recall that on March 18, 1971 the Federal Power Commission issued its Order No. 428, 45 FPC 454 (1971), which provided a blanket

certificate procedure for small producers of natural gas and relieved them of almost all filing requirements. The rates of small producers would, under Order No. 428, no longer be directly regulated but be subjected to indirect regulation through the review of purchased gas costs of the pipelines and large producers to whom the small producers sold their product.

This regime of indirect regulation of rates for small producers was attacked in the federal courts. On December 12, 1972 the United States Court of Appeals for the District of Columbia Circuit in *Texaco* v. *F.P.C.*, 474 F.2d 416, set aside and held invalid Commission Order No. 428, the Court of Appeals holding that the Commission had exceeded its authority in exempting small producers from direct price regulation. An appeal was taken to this Court.

On June 10, 1974 this Court, in *F.P.C.* v. *Texaco*, *supra*, vacated the judgment of the Court of Appeals and remanded the case to that court with instructions to remand the case to the Commission for further proceedings consistent with the Supreme Court's opinion. Then, on September 9, 1974, the Commission, in its Docket No. R-393 (the Order No. 428 docket) issued a Notice of Proposed Rule Making to establish just and reasonable rates for the sale of gas by small producers. Nearly a year later, on August 28, 1975, the Commission, in its Docket No. R-393 issued its Opinion No. 742, 54 FPC 853, directing that the just and reasonable ceiling rates for small producer sales may be 130% of the applicable rates for a comparable sale by a large producer.

This case involves the interpretation of the pricing provision of three agreements covering the sale of nat-

ural gas by the respondent to the petitioner. Two of the gas purchase agreements were entered into when the Court of Appeals' decision in *Texaco* v. *F.P.C.*, *supra*, was pending before this Court. The third agreement was executed after the decision by this Court in *F.P.C.* v. *Texaco*, *supra*, but before the Commission issued its Opinion No. 742.

This case superficially involves only the interpretation of the pricing provisions of three contracts, which pricing provisions are virtually identical. As such, the case would not seem to involve principles the settlement of which is of importance to the public as distinguished from that of the parties. However, the case does involve important public issues, because the opinion of the Court of Appeals reversing the trial court's judgment turned on the specific finding by the Court of Appeals that this Court, in *F.P.C.* v. *Texaco*, *supra*, had "vacated the No. 428 Order" and made Order No. 428 not effective (Appendix A, infra, page A-18). As will be indicated under Reasons For Granting Writ, infra, such a holding by a Court of Appeals which holding is clearly at variance with the written opinion of this Court in *F.P.C.* v. *Texaco*, *supra*, may open to question the pricing provisions of numerous — perhaps hundreds — of gas purchase agreements executed in the United States during the period from the Commission's adoption of Order No. 428 and its subsequent adoption of Opinions No. 742 and 742-A. The impact upon the natural gas consuming public of such a decision, if left undisturbed, amounts to more than three million dollars with reference only to the three gas purchase contracts involved in the instant proceeding. The total impact upon the natural gas consuming public, due to the possible upward revision in prices paid to small

producers by other purchasers who executed contracts during the period in question, could have a most significant economic effect, although impossible of measurement by the petitioner since it is unknown how many such contracts have been executed by numerous purchasers other than the petitioner.

The significance of the decision of the Court of Appeals that this Court "vacated" Commission Order No. 428 and announced it to be ineffective arises in the instant proceeding from the terms of one of the paragraphs in the pricing provisions contained in all three contracts in substantially the same form. The paragraph is as follows:

> If F.P.C. Order No. 428, as modified, is determined not to be effective with respect to the sale of gas hereunder, then the price charged for gas purchased and sold hereunder shall be such price as is permitted to be effective by the Federal Power Commission and Seller agrees to refund amounts paid by Northern in excess of such price.

The Court of Appeals, after holding that F.P.C. Order No. 428 was vacated by this Court in *F.P.C.* v. *Texaco, supra*, and not effective with respect to the sale of gas under such contracts, went on to determine that the balance of the above quoted paragraph was equivalent to an "area rate clause," as such clause is defined in 18 C.F.R., Section 154.93(b-1). Such a finding resulted in a reversal of the trial judge's judgment, which was based upon his ascertainment of the intent of the parties as expressed in the written agreements and circumstances surrounding the negotiation of the agreements, which intention was that the pricing provision above quoted was intended to operate only as a means

of the petitioner's obtaining a refund of those monies paid for the purchase of the respondent's natural gas that were in excess of the amounts that might be charged if the higher prices negotiated pursuant to the Order No. 428 regime were ever held to be ineffective. The finding by the Court of Appeals that the clause above quoted also was equivalent to an "area rate clause" is also cited herein as error, although no public policy considerations attend the review by this court of such believed error by the Court of Appeals. Nevertheless, should the Court decide to review the decision of the Court of Appeals, this question should also be reviewed in order to fully dispose of the issues between the parties.

The Court of Appeals, in holding that this Court in *F.P.C.* v. *Texaco, Inc., supra*, vacated Commission Order No. 428, relied upon the following statement by this Court in such decision:

> In this posture of the case, we think it clear that Order No. 428 cannot stand in its present form and that the cases should be remanded for further proceedings before the Commission. We have studied the order with care, and we cannot accept the construction of it that the Commission now presses upon us. At the very least, the order is so ambiguous that it falls short of that standard of clarity that administrative orders must exhibit. 417 U.S. 380 at 395-396.

Reliance upon this statement, which was in the body of this Court's opinion, was clearly in error and amounted to deciding a federal question in a way in conflict with a decision of this Court. This Court, in *F.P.C.* v. *Texaco, supra*, after making the above quoted statement went on to decide as follows:

> We agree with the Court of Appeals that the order of the Commission must be set aside; but for reasons previously stated, we vacate the judgment of the Court of Appeals and remand the cases to that court with instructions to remand the cases to the Commission for further proceedings consistent with this opinion.
>
> Vacated and remanded. 417 U.S. at 401.

The above represents the decision of this Court in *F.P.C.* v. *Texaco, supra.* This Court did not vacate Order No. 428. This Court vacated the judgment of the Court of Appeals. Since the Court of Appeals, in *Texaco* v. *F.P.C., supra,* earlier had set aside Order No. 428, this Court effectively held that Order No. 428 would continue in full force and effect until such time as the Commission would be able to have further proceedings consistent with the opinion of this Court.

The Court of Appeals was manifestly in error.

The only issue remaining is whether the Commission, when it handed down its Opinion No. 742, vacated, voided or held ineffective the Order No. 428 regime of indirect regulation of small producer prices that existed during the period from March 18, 1971, when Order No. 428 was adopted, until August 28, 1975, when it issued its Opinion No. 742 or later, when on July 28, 1976, the Commission in further proceedings in its Docket No. R-393 issued its Opinion No. 742-A allowing to small producers the higher national rates prescribed in its Opinion No. 770, together with the 130% differential allowed to small producers under Opinion No. 742.

It is clear from a single reading of Opinion No. 742 (Appendix A, infra, page A-23) that the Commission did not void, vacate or hold ineffective its Order No. 428.

The first paragraph of Opinion No. 742 states that the blanket certificate procedure for small producers set forth in Order No. 428 has not been abandoned:

> The Commission, on September 9, 1974, issued a Notice of Proposed Rulemaking in this proceding (39 F.R. 33241, September 16, 1974) proposing to establish a just and reasonable rate differential for sales made by small producers pursuant to the blanket certificate procedures set forth in Order No. 428, 45 FPC 454, above the base rate . . . established for large producers in a Commission order of general applicability.

The Commission next proceeded to discuss factors justifying a higher rate for small producers and determined that the just and reasonable rate for small producers should be 130% that of large producers. Having established a ceiling on just and reasonable rates for small producers, the Commission next grappled with the question of how it would handle situations where a small producer was then collecting a rate under an existing contract in excess of the just and reasonable rate. The Commission stated as follows:

> United Gas Pipe Line Company (United) contends that where a small producer is collecting a rate under an existing contract in excess of the just and reasonable rate, the small producer should be required under Section 5 of the Natural Gas Act to reduce its rate. Otherwise, United argues, the pipeline would be penalized *ad infinitum* for paying an above-ceiling rate. El Paso, on the other hand, contends that pipeline purchasers should not

> be required to absorb purchased gas costs with respect to above-ceiling purchases from small producers under existing contracts because the rules have changed since the issuance of Order No. 428. As we indicated in the September 9 Notice, mimeo p. 9, *we do not intend to require small producers to make refunds of above-ceiling rates for sales made pursuant to temporary or permanent certificates under Order No. 428* (quoting *F.P.C.* v. *Texaco, supra*). The Section 5 question, however, will be decided either in each individual pipeline case or in the rule-making proceeding in Docket No. RM76-5, relating to our proposal to require small producers *prospectively* to reduce their rates to the applicable just and reasonable ceiling established in this proceeding. The arguments advanced by El Paso should be taken into consideration in pipeline rate cases in determining whether to allow a pipeline to recover above-ceiling rates paid to small producers under existing contracts. (Appendix A, infra, page A-32). (Emphasis added)

Nothing could be clearer. Opinion No. 742 did not require a small producer who had negotiated a rate during the period in question that was higher than the 130% differential provided by Opinion No. 742 to reduce its rate or to make refunds of above-ceiling amounts collected under such a contract. This point was made again, later in Opinion No. 742:

> United and PSCNY have pointed out, quite properly, that Section 157.40(f) relating to filings by large producers with respect to the resale of gas purchased from small producers should be modified in accordance with *F.P.C.* v. *Texaco, Inc., supra*, and we shall so modify that section. In judging whether to suspend such a large producer filing, we will be guided by our determination here as to the just and reasonable rate for a small producer

> sale and the size of the differential between the purchase price from the small producer and the resale price by the large producer. If a proposed rate is suspended because the small producer price exceeds the just and reasonable rate established in this case, then the same standards will apply in determining whether to allow a large producer to recover such costs as apply to similar pipeline purchases. And, if a proposed rate is suspended because of the differential between the purchase and resale price, we will determine the just and reasonable differential. (Appendix A, infra, pages A-34, A-35)

It has earlier been shown that this Court in *F.P.C.* v. *Texaco, supra,* did not "vacate the Commission's Order No. 428." The above statements of the Commission in Opinion No. 742 likewise show that the Commission did not vacate or hold ineffective Order No. 428 as it applied to rates negotiated by small producers during the period between the adoption by the Commission of Order No. 428 and the Commission's subsequent adoption of its Opinion No. 742 in response to the opinion of this Court in *F.P.C.* v. *Texaco, supra.*

The Court of Appeals was in error.

REASONS FOR GRANTING WRIT

It has been stated that this Court should not grant certiorari except in cases involving principles the settlement of which is of importance to the public as distinguished from the parties. *Layne & Bowler Corp.* v. *Western Well Works, Inc.*, 261 U.S. 387 (1923). In *NLRB* v. *International Van Lines,* 409 U.S. 48 (1972) this Court granted certiorari because the case involved principles important to the administration of the National Labor Relations Act. It is submitted that this

case, while superficially involving only the construction of the terms of three contracts, does involve principles the settlement of which is of importance to the public and does involve principles important to the administration of the Natural Gas Act, 52 Stat. 821, 15 U.S.C., Sections 717 et seq.

The Commission's Order No. 428 clearly has never been held by this Court or the Commission to be void or ineffective with respect to contracts, involving the sale of natural gas by small producers to interstate pipeline companies, executed during the period from March 18, 1971 to July 28, 1976. It is impossible for the petitioner to know how many hundreds of gas purchase agreements were executed during this period by all pipeline companies and large producers, on the one hand, and small producers on the other hand. It is also impossible for the petitioner to know how the decision of the Court of Appeals below will affect the interpretation of such gas purchase agreements. The petitioner is able to state, however, that the decision of the Court of Appeals in this case, if not reviewed and reversed by this Court, will have the effect of passing on to the natural gas consuming public the burden of paying more than three million dollars in increased natural gas prices attributable solely to the three gas purchase contracts which are the subject of this case. It may well be that many millions of dollars in increased natural gas prices will have to be borne by the natural gas consuming public as a result of the decision the review of which is here petitioned. This Court has earlier deemed a question to be an important one for certiorari where a large amount of money was involved and the liability of a number of persons would remain

uncertain until a dispute was finally settled. *United States* v. *Constantine*, 296 U.S. 287 (1935).

Rule 19 of the Rules of the Supreme Court of the United States provides that one of the reasons which will be considered by the Court in determining whether to grant a review on writ of certiorari is the following:

> (b) Where a court of appeals . . . has decided a federal question in a way in conflict with applicable decisions of this court;

The Court of Appeals has clearly erred in holding that this court, in *F.P.C.* v. *Texaco, supra*, "vacated the No. 428 Order." (Appendix A, infra, page A-18). This erroneous statement of a federal question is in conflict with an applicable decision of this Court. Such a misstatement could have a most mischeivous impact upon the interpretation of hundreds of gas purchase agreements executed during the period in question, which impact will bear directly upon the prices to be paid by the natural gas consuming public in the years ahead for natural gas the purchase price of which is governed by gas purchase agreements that can be affected by this decision of the Court of Appeals.

CONCLUSION

For the foregoing reasons this petition for a writ of certiorari should be granted.

Respectfully submitted,

/s/ THOMAS J. KENAN

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May 7, 1980

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CERTIFICATE OF SERVICE

I, Thomas J. Kenan, a member of the Bar of the Supreme Court of the United States and counsel of record for Northern Natural Gas Company (now InterNorth, Inc.), petitioner herein, hereby certify that on May 8, 1980, pursuant to Rule 33, Rules of the Supreme Court, I served three copies of the foregoing Petition for Writ of Certiorari on each of the parties herein, as follows:

On Charles L. Birke, Sandler & Rosen, 1801 Avenue of the Stars, Suite 510, Los Angeles, California 90067, counsel for the respondent herein, by depositing such copies in the United States Post Office, Oklahoma City, Oklahoma, with first class postage prepaid, properly addressed to the above post office address of said counsel.

All parties required to be served have been served.

Dated May 8, 1980.

/s/ THOMAS J. KENAN

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Oklahoma City, Oklahoma 73102

APPENDIX A

Index

Opinion of the United States Court of Appeals, Tenth Circuit of March 4, 1980 ..... A-1

Opinion No. 742 of the Federal Power Commission issued on August 28, 1975 ..... A-23

Recall of Mandate of March 26, 1980 of the United States Court of Appeals, Tenth Circuit, issued on April 18, 1980 ..... A-48

Opinion of the Honorable Luther B. Eubanks, United States District Judge for the Western District of Oklahoma, of November 17, 1978 in Premier Resources, Ltd. vs. Northern Natural Gas Company A-49

PUBLISH

United States Court of Appeals

TENTH CIRCUIT

Filed
March 4, 1980

No. 78-2014

PREMIER RESOURCES, LTD.,
Plaintiff-Appellant,

v.

NORTHERN NATURAL GAS COMPANY,
Defendant-Appellee.

Appeal from the United States District Court for the Western District of Oklahoma
(D.C. No. CIV-78-0201-E)

Charles L. Birke of Sandler and Rosen, Los Angeles, California, for Plaintiff-Appellant.

Thomas J. Kenan of George, Kenan, Robertson & Lindsey, Oklahoma City, Oklahoma (Patrick J. McCarthy, Northern Natural Gas Company, Omaha, Nebraska, and James W. McCall of George, Kenan, Robertson & Lindsey, with him on the brief), for Defendant-Appellee.

Before DOYLE, BREITENSTEIN and MCKAY, Circuit Judges.

DOYLE, Circuit Judge.

This is a natural gas pricing case. Premier Resources, Ltd., the appellant herein, seeks reversal of a judgment rendered by the United States District Court for the Western District of Oklahoma, in favor of the defendant-appellee, Northern Natural Gas Company. Premier is a Colorado corporation engaged in oil and gas exploration and production, and has its principal place of business in Denver. It is what is known in the industry as a small producer of natural gas and is certified by the Federal Power Commission, or the Federal Energy Regulatory Commission, as it is now called. Northern, on the other hand, is a Delaware corporation which has its principal place of business in Omaha, Nebraska, and is essentially an interstate pipeline company.

Premier and Northern had entered into a series of three contracts on February 12, 1973, November 14, 1973, and September 18, 1974. Each of these provided for the sale by Premier to Northern of gas from wells in the Hugoton-Anadarko area, located in Kansas, Oklahoma and Texas. The matter in issue is the amount Premier was entitled to receive for its gas; whether the terms of the contract governed for the period following July 27, 1976, or whether FPC Order No. 742-A, which was adopted on the date just mentioned and which established higher ceiling prices for small-producer sales than had been allowable at the time of execution of the contracts, set the price level. This contract of pricing was not disapproved by the Supreme Court, but was changed by the Commission afterwards.

The district court ruled in favor of Northern. It found that the pricing provisions of the contracts were "to some extent uncertain and indefinite," and received evidence to clear up the ambiguities. A particular clause

which is in all three contracts, the meaning of which is in issue, reads as follows:

> If FPC Order No. 428, as modified, is determined not to be effective with respect to the sale of gas hereunder, then the price charged for gas purchased and sold hereunder shall be such price as is permitted to be effective by the Federal Power Commission and Seller [Premier] agrees to refund amounts paid by Northern in excess of such price.

This provision was included in each of the three mentioned contracts to cover a possible contingency, that of a declaration by the Supreme Court of the United States rendering noneffective Order No. 428, a simplified pricing measure for small producers, which will be discussed presently.

HISTORY AND BACKGROUND

In 1971, the FPC issued its Order No. 428 (which was later modified by Order Nos. 428-A and 428-B). Number 428 exempted present and future sales of natural gas by FPC-certified "small producers" from direct rate regulation. The purpose of the promulgation of No. 428 was to encourage exploration by small producers and to encourage also their engaging in interstate natural gas production and their competing in the natural gas market. The order exempted small producers from the fixed area rate ceilings imposed by the FPC on large producers.[1] It allowed, with certain limitations, small producers to charge prevailing market prices for their gas.

---

1. *See generally In re Permian Basin Area Rate Cases*, 390 U.S. 747 (1968) (upholding the authority of the FPC to establish a system of area rate regulation for large producers).

It was not the object of No. 428 to deregulate the small producers altogether. It sought, however, to limit the regulation by establishing a system of indirect regulation. This consisted of requiring pipeline companies to justify that the prices paid to the small producers were reasonable as a condition to their being able to pass on the differences to their own customers.

Texaco, Inc. challenged this exemption in a suit filed in the United States Court of Appeals for the District of Columbia. That court ruled that No. 428 of the FPC exceeded the authority delegated to the FPC under the Natural Gas Act, 15 U. S. C. §§ 717 *et. seq. See* Texaco, Inc. v. FPC, 474 F.2d 416 (D.C. Cir. 1972). Review was obtained in the Supreme Court, and on June 10, 1974, the Supreme Court gave its ruling. See FPC v. Texaco, Inc., 417 U.S. 380 (1974). It held that Order No. 428 of the FPC was invalid. The court held that indirect regulation through the mechanism of controlling large producers costs would not merely recreate the situation which the Court in the case of Phillips Petroleum Co. v. Wisconsin, 347 U.S. 672 (1954), found to be inconsistent with the Natural Gas Act. The Court found that allowing the small producers initially to charge what the market will bear and relying on later regulation of pipeline rates to protect the consumer was contrary to Atlantic Refining Co. v. Public Service Comm'n, 360 U.S. 378 (1959). In effect, the Supreme Court held that Order No. 428 failed to provide a mechanism for insuring that small-producer rates would be just and reasonable; that a market standard such as was employed in Order No. 428 did not satisfy the Act. The Court said:

> In this posture of the case, we think it clear that Order No. 428 cannot stand in its present form

> and that the cases should be remanded for further proceedings before the Commission. We have studied the order with care, and we cannot accept the construction of it that the Commission now presses upon us. At the very least, the order is so ambiguous that it falls short of that standard of clarity that administrative orders must exhibit.

417 U.S. at 395-396. Essentially, it was the failure to insure the application of the just and reasonable standard that was condemned.

The Court added that "* * * we should also stress that in our view the prevailing price in the marketplace cannot be the final measure of 'just and reasonable' rates mandated by the Act." 417 U.S. at 397. The Court stressed that market price and "just and reasonable", although related, are not synonymous. The Court's final conclusion was that the Commission lacked the authority to rely exclusively on market prices in fixing just and reasonable rates. The Court said, however, that it was not condemning indirect regulation of small producers by reviewing pipeline costs of purchased gas so long as the Commission saw to it that the rates paid by pipelines, and ultimately borne by the consumer, were just and reasonable. The Court recognized or conceded that insuring just and reasonable rates by means of indirect regulation might not be feasible.

The *Texaco* decision was announced June 10, 1974. On August 28, 1975, following the remand of the *Texaco* case, the FPC issued its Opinion No. 742.[2] This opinion established a new system of direct regulation of small

2. Opinion No. 742 was part of the FPC's Docket No. R-393, the same docket that included Order No. 428.

producers. It set rate ceilings for small producers at 130% of the applicable area rate for comparable sales by large producers.

Following this, the FPC issued its Opinion No. 770, on July 27, 1976, eliminating variable area rate ceilings in favor of new, uniform national rates for large-producer sales of natural gas in interstate commerce. National rates of $1.01 per Mcf for 1973-74 biennium gas and $1.42 for 1975-76 biennium gas were established. The rate of $1.01 per Mcf was modified downward to 93 cents per Mcf in a subsequent FPC Opinion No. 770-A. These two opinions were upheld in American Public Gas Ass'n v. FPC, 567 F.2d 1016 (D.C. Cir. 1977), *cert. denied*, 425 U.S. 907 (1978).

On July 28, 1976, the FPC issued its Opinion No. 742-A which reaffirmed that small producers were entitled to higher rates of return than large producers, and that small producers could charge up to 130% of the national rates which were prescribed in Opinion Nos. 770 and 770-A. After that, Premier demanded from Northern increased prices under the three contracts in suit. This demand was pursuant to the FPC Opinion No. 742-A.

We must be mindful that the February 1973 contract and the November 1973 contract came into existence prior to the Supreme Court's decision in FPC v. Texaco, Inc., *supra*, and the September 1974 contract was executed following the Supreme Court's decision in *Texaco* but prior to the FPC proceedings on remand which culminated in issuance of the FPC Opinion No. 742-A which raised substantially the rates allowable to small producers.

Article V, the price provision for each of the contracts, established an initial price of 46 cents per Mcf for gas delivered during the first year of the contract. During the second year, the price was increased to 46.5 cents per Mcf. This Article also contained a so-called redetermination clause which provided a method for increasing contract prices at five-year intervals. It required renegotiation to commence three months before the beginning of the third contract year. The price was redetermined for the succeeding five-year period. The redetermined price provided for was the highest price contained in any contract executed by Northern for the purchase of gas in the county in which the well is located. Similarly, the price was redetermined three months prior to the end of each subsequent five-year period. Article V also provided that the contract price would never be reduced in any price renegotiations.

Pursuant to the redetermination clauses of the contracts, amendments to each contract were executed in 1975 and 1976 which established new, higher rates for natural gas sold for the first five-year terms of each contract. A price range of from 53.0 cents to 79.05 cents per Mcf was established for the February 1973 contract wells, and a price of from 63.6 cents to 80.75 cents was set for the November 1973 contract wells. A price of 60.08 cents per Mcf was established for natural gas delivered under the September 1974 contract.

Three contingency clauses affected prices determined under the redetermination clause. The first was concerned with the possibility of FPC deregulation; the second concerned itself with the possibility that the FPC might not allow a portion of the contract price to be

included in Northern's rate base. The third proviso is the clause which is the heart of the dispute here. It provides as follows:

> If FPC Order No. 428, as modified, is determined not to be effective with respect to the sale of gas hereunder, then the price charged for gas purchased and sold hereunder shall be such price as is permitted to be effective by the Federal Power Commission and Seller agrees to refund amounts paid by Northern in excess of such price.

There was only a minor difference between the three contracts. The two 1973 contracts were the same. The 1974 contract contains the word "finally" before the word "modified" in the Order No. 428 provision.

Once a price is agreed upon in a contract there are a limited number of ways under FPC regulations for modifying the price. The FPC-approved provisions for a change of price are published in 18 C. F. R. § 154.93 as follows:

> *Provided*, That in contracts executed on or after April 3, 1961, for the sale or transportation of natural gas subject to the jurisdiction of the Commission, any provision for a change of price other than the following provisions shall be inoperative and of no effect at law; the permissible provisions for a change in price are:
>
> (a) Provisions that change a price in order to reimburse the seller for all or any part of the changes in production, severance, or gathering taxes levied upon the seller;
>
> (b) Provisions that change a price to a specific amount at a definite date;

> (b-1) Provisions that permit a change in price to the applicable just and reasonable area ceiling rate which has been, or which may be, prescribed by the Commission for the quality of the gas involved; and
>
> (c) Provisions that, once in five-year contract periods during which there is no provision for a change in price to a specific amount (paragraph (b) of this section), change a price at a definite date by a price-redetermination based upon and not higher than a producer rate or producer rates which are subject to the jurisdiction of the Commission, are not in issue in suspension or certificate proceedings, and are in the area of the price in question . . . .

It is the meaning of the "Order No. 428" clause in the contract above which is the center of contention here. The issue is whether this clause operates to change the contract price to the applicable "just and reasonable area ceiling rates which has been, or which may be, prescribed by the Commission for the quality of the gas involved" within the meaning of subsection (b-1) of 18 C.F.R. § 154.93. Subsection (b-1), as noted, contains a formula for a change in the contract price. It refers to area rate clauses, and the important character in an area rate clause in a contract is that it calls for automatic escalation of the contract price to coincide with increases in ceiling rates established by the FPC for natural gas sales.

Is the Order No. 428 clause contained in the contract tantamount to an area rate clause within the meaning of subsection (b-1), 18 C.F.R. § 154.93? The two provisions can be compared if they are examined together. So, we set them forth as follows:

> If FPC Order No. 428, as modified, is determined not to be effective with respect to the sale of gas hereunder, then the price charged for gas purchased and sold hereunder shall be such price as is permitted to be effective by the Federal Power Commission and Seller agrees to refund amounts paid by Northern in excess of such price.
>
> * * * * * *
>
> (b-1) Provisions that permit a change in price to the applicable just and reasonable area ceiling rate which has been, or which may be, prescribed by the Commission for the quality of the gas involved; . . .

The elements of (b-1) are tied to a just and reasonable area ceiling rate as may be prescribed by the Commission. The Order No. 428 clause says that in the event of the contingency (whereby Order No. 428 is determined not to be effective), then "the price charged for gas purchased and sold shall be that permitted * * * by the Federal Power Commission." Subsection (b-1) authorizes "Provisions that permit a change in price to the applicable just and reasonable area ceiling rate * * * which may be, prescribed by the Commission . . ." Do the provisions of the Order No. 428 clause satisfy the requirements of subsection (b-1) which "permit[s] a change in price to the applicable area ceiling rate * * * prescribed by the Commission"?

It is Premier's position that the Order No. 428 clause included in the contracts in question was intended to operate as an area rate clause. Northern denies this emphatically, of course. It contends that the Order No. 428 clause in the contracts had a special purpose. It was intended as a "roll-back" provision only to cover

the possibility that the Supreme Court in the *Texaco* case might rule that the higher contract prices contained in the Premier contracts and the contracts of other small producers were illegal. Northern says that if the Supreme Court or the FPC had ordered a retroactive roll-back of prices in small-producer contracts to the rates applicable to large producers, the Order No. 428 clause would have required Premier to refund any excess that Northern paid over the maximum prices permitted. Thus, Northern's interpretation of this clause is that it operates only to lower prices. It has no function where the Commission has increased the price as it has here. The trouble is that it falls short of so providing.

Premier argues that the clause was not a one-edged sword; that it cut both ways, and was also intended by its terms to allow the contract prices to *rise* should the FPC permit increases in small-producer rates as they did here. Premier argues that the language of No. 428 calls for automatic escalation of the contract prices up to the new levels; that it does not make any distinction between increase of prices and decrease of prices.

THE TRIAL COURT'S RULING

The trial court ruled in favor of Northern. It held that Article V of the contract was devoid of an area rate clause and, of course, that the Order No. 428 clause did not have this effect. The judge ruled that, as a consequence, the prices as redetermined prior to the third year of each of the contracts remained fixed for five years pursuant to the redetermination clause, and that under 18 C.F.R. § 154.93(c) the redetermined prices could not be changed within the five-year period.

The judge in effect ruled that FPC Order No. 428 had been determined not to be effective within the meaning of the 428 clause.[3]

The judge stated that "428 apparently was held [by] the Supreme Court to be no impediment at all to a small producer getting a greater amount than the area rate for a large producer."

In seeking reversal, Premier specifies four issues. First, it contends that the trial court's conclusion was based on the mistaken impression that Premier had stipulated to a certain interpretation of 18 C.F.R. § 154.93. Second, Premier argues that neither Order No. 428 nor 18 C.F.R. § 154.93 precluded the parties from including both a redetermination clause and an area rate clause in the same contract. Third, Premier contends that the language of the Order No. 428 paragraph required the contract prices to rise to the ceiling rates after the Supreme Court's decision in the *Texaco* case. The fourth and final contention is that certain language in the redetermination clause had the effect of incorporating by reference price escalations in contracts in the counties where Premier's wells were located. We need not consider the fourth question in view of our decision.

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3. As to the question whether the Order No. 428 clause had been determined not to be effective, we are referring to the following:

> If FPC Order No. 428, as modified, is determined not to be effective with respect to the sale of gas hereunder, then the price charged for gas purchased and sold hereunder shall be such price as is permitted to be effective by the Federal Power Commission and Seller agrees to refund amounts paid by Northern in excess of such price.

I.

The first of Premier's contentions is that the trial court's finding is based on a mistaken impression that Premier had stipulated to a set interpretation of 18 C.F.R. § 154.93. What the court said was:

> This indeed is a two edged sword in this contract. But, what we have got to stop and recognize is — and this is really not disputed here — there are just two formulas or methods of price determination in the industry. One is the area rate clause, and that is not our case because the area rate clause is just not here. I will say why in a moment. The other is the redetermination or renegotiation proviso, which it is undisputed here under the law, can not be redetermined more often than once every five years excepting only after their initial discovery and the first redetermination can be after three years. Now, that is the way that I understand both sides interpret this Section 154.93 of the FPC Regulations, and that is mentioned in Article 5 of the contract.

It cannot be said that Premier made any stipulation of the kind described. Of course, Premier does not dispute the terms of Article V and the five-year clause. However, Premier has not manifested that it agrees that the contract lacks a clause which amounts in substance to an area rate clause. That is what this lawsuit is all about. The contention of Premier is that the FPC Order No. 428 is tantamount to an area rate clause. One of the difficulties with the trial court's decision is that the judge did not consider the similarity between the area rate clause and the Order No. 428 clause which we have noted above. We shall discuss the question as to whether the No. 428 clause satisfied

the requirement of an area rate clause in the contract which is set forth among the other escape clauses.

The further contention of Premier is that the trial court had misconstrued the testimony of Malcolm Crawford; that Crawford had testified to the effect that during the negotiations he understood that the contract price was for a fixed period of time which was required by the FPC. We fail to see that it has any relevance because, to be sure, the price provided in the contract was for a definite period of time, but 18 C.F.R. § 154.93 contains four grounds whereby the contract prices can be modified. Hence, this does not constitute an injurious admission.

II.

The next contention of Premier is that neither the FPC Order No. 428 nor 18 C.F.R. § 154.93 prohibited the parties from contracting for prices that would be fixed for a certain period, yet at the same time would be subject to increases to conform to new ceiling rates adopted by the FPC during that period. Premier maintains that the trial judge was in error in assuming that natural gas sales contracts could contain either redetermination clauses or area rate clauses as vehicles for increasing rates, but could not have both.

However, this is no issue because Northern acknowledges in its brief that 18 C.F.R. § 154.93 does not prevent inclusion of both subsection (b-1) area rate clauses and subsection (c) redetermination clauses. Examination of 18 C.F.R. § 154.93 readily shows that these permissible price provisions are not mutually exclusive. There is no reason why a natural gas purchase and sale contract cannot include more than one type of FPC-

approved price provision. Northern does not deny this, and as we read the trial court's opinion it does not really come to grips with this question, but if it implies that both redetermination clauses and area rate clauses cannot be in the same contract, it would be in error. The judge was asked by counsel for Premier whether the judge was saying that as a result of 18 C.F.R. § 154.93 whether it would be impermissible for the price to go up. The judge said, "No, I didn't say that at all. I say, if you have an area rate clause in there, of course you can go up. But, absent a rate clause and falling back on this one that was in this contract, the redetermination-renegotiation clause, that under that regulation you can not redetermine oftener than five years . . . ."

Insofar as the trial judge may have given the impression that the five-year duration clause was set in concrete, it was, of course, incorrect. So, the judge's assumption was that the Order No. 428 clause was not tantamount to an area rate clause for this limited purpose. If it is determined that the No. 428 paragraph fills the requirements of an area rate clause, the result is just the opposite from that which the judge reached.[4]

III.

Premier's next argument, the ultimate and decisive issue in the case, concerns the interpretation of the Order No. 428 clause. Its argument is that it contains the language of an area rate clause, whereby the contract price can rise in the wake of the decision of the

4. Northern, of course, does not agree with Premier's thesis that the Order No. 428 clause satisfied the area rate clause requirement.

Supreme Court in *Texaco* and the adoption by the FPC of Order No. 742-A.

Premier points to the fact that the contract was drafted by Northern, but in view of the fact that we consider the Order No. 428 clause to be unambiguous, this doctrine is of limited value. We do note, however, that Oklahoma law recognizes that:

> In cases of uncertainty *not removed by the preceding rules*, the language of a contract should be interpreted most strongly against the party who caused the uncertainty to exist . . . .

Okla. Stat. Ann. tit. 15 § 170 (West, 1966) (emphasis added). *See also* Cities Service Oil Co. v. Geolograph Co., 208 Okla. 179, 254 P.2d 775, 782 (1953); Replogle v. Indian Territory Illuminating Oil Co., 193 Okla. 361, 143 P.2d 1002, 1008 (1943). Apparently Northern was allowed to draft the contracts because of its having had more experience doing so.

These rules are not, it is true, talismanic. It is said that they are to be applied only after all other rules of contract interpretation have been tried. *See* 3 *Corbin on Contracts* § 559 (1960), at 268. Oklahoma law is to the effect that in the case of uncertainty not removed by the preceding rules, the language of a contract should be interpreted most strongly against the party who caused the uncertainty to exist.

Testimony was offered on behalf of Northern that it is customary in the industry for the purchasers of natural gas to draft the sales contracts. Northern had considerable experience in formulating language that would be acceptable to the FPC. We recognize all of this, but it does not mean that the language of the

clause before us should not be read at least in accordance with Oklahoma law.

There are two questions to be considered in interpreting the Order No. 428 clause. The first of these is whether the contingency was met, that is, whether Order No. 428 was determined not to be effective within the meaning of this clause, and, secondly, assuming the contingency was fulfilled, that is, if the Supreme Court held that it is not effective, whether the language of the clause required the contract price to escalate to the higher ceiling rates established by the FPC after the contracts were executed.

A.

Premier's position is that FPC Order No. 428 was determined not to be effective within the meaning of the No. 428 clause. In the Supreme Court's decision in *Texaco*, it is to be recalled that the Supreme Court did not outlaw contract pricing or indirect pricing. It did, however, hold that Order No. 428 did not provide any clear standards and remanded the cause for further proceedings. Northern, of course, maintains that the Supreme Court held that although it remanded the case, that FPC Order No. 428 was still effective. The trial court stated on this subject that "428 apparently was held [by] the Supreme Court to be no impediment at all to a small producer getting a greater amount than the area rate for a large producer."

There is nothing to be gained from quibbling about whether it was invalidated since the only question for us is that which is contained in Article V of the contract, which says that

> If FPC Order No. 428, as modified, is determined *not to be effective* with respect to the sale of gas hereunder, then the price charged for gas purchased and sold hereunder shall be such price as is permitted to be effective by the Federal Power Commission and Seller [Premier] agrees to refund amounts paid by Northern in excess of such price. (Emphasis added.)

It cannot be successfully contended that FPC Order No. 428 was determined not to be effective with respect to the sale of gas hereunder; that it was merely a rebate clause. The Supreme Court vacated the No. 428 Order and remanded it ultimately to the Commission for the purpose of adopting clear standards which conformed to the just and reasonable requirement. Following the remand to the Commission, that latter body reestablished a system of direct regulation of small producers and set rate ceilings for small-producer sales of 130% of the applicable area rate for comparable sales by large producers. The Commission then proceeded to change its regulation methods as to rates of large producers.

We must reject Northern's contention that the Supreme Court's holding was something less than a determination that Order No. 428 was not to be effective. Therefore, the No. 428 clause in the contract before us became effective.

B.

The next question is whether the further language in the No. 428 clause that the price for gas purchased and sold shall be such price as is permitted to be effective by the Federal Power Commission amounts to the same thing as an area rate clause. As noted above, subsection (b-1) of 18 C.F.R. § 154.93 does define area rate clause

in general terms. In other words, it does not prescribe that it must be labeled as an area rate clause. It need only provide for a change in price to the applicable just and reasonable area ceiling rate which has been, or which may be, prescribed by the Commission. Premier maintains that the trial court was in error in failing to examine the language of the No. 428 clause and to compare it to § 154.93(b-1), which permits a change in price to the applicable area ceiling rate. Both the No. 428 clause and subsection (b-1) are, as we have noted above, geared to a rate prescribed by the Commission.

Northern's position in this regard is based on the single proposition that the No. 428 clause was designed to bring about a price adjustment downward in the event that it was determined that small producers could no longer lawfully charge higher contract prices for their gas; that it was a "roll-back" provision designed for the protection of Northern stockholders, whereby they would not be required to absorb a loss representing the difference between the contract price and the maximum amount that could be included in Northern's rate base. Northern put into evidence a sample area rate clause contained in a contract between Northern and some other gas producer. Needless to say, it is not written in the same brief terms as the Order No. 428 clause. It contains all kinds of provisions other than the simple definition in 18 C.F.R. § 154.93(b-1). It lists several contingencies. If that particular clause was the definition instead of subsection (b-1), Northern would win the day hands down. But the official definition is that promulgated by the Commission in 18 C.F.R. § 154.93(b-1).

Northern relies on the proviso in the last clause of the No. 428 provision which says that "and Seller agrees to refund amounts paid by Northern in excess of such price." This clause is not applicable because the price of gas was not reduced. Its presence is not inimical to the conclusion that the No. 428 clause was intended to apply to increases as well as decreases in the rates. Had it been intended to apply to decreases only, it would have been simple for Northern to have so written it. Had it done so, Premier would have been alerted to the contention that is now being raised.

Testimony at the trial was offered showing that the contract negotiations were largely devoted to financing arrangements under which Northern would advance payments to Premier to assist in defraying its drilling expenses. The testimony was that Northern would pay the highest possible initial price for Premier's gas. But, William J. Poehling, who testified for Northern, said that it was not Northern's practice to include area rates clauses in sales contracts.

Northern's testimony as to the object of the Order No. 428 clause was that it was intended exclusively to benefit Northern, that is, as a refund provision.

The Premier position was that the clause was to operate two ways, either to offer a refund if a roll-back was ordered, or give Premier the benefits of any higher rates subsequently established by the FPC.

Does the additional covenant given by Premier to refund any amounts in excess of the permitted price supports add anything?

We think not. It would apply only in the event of the contingency of the FPC reducing the rates. We are

of the opinion that the clause does satisfy all of the requirements of the subsection (b-1) definition contained in 18 C.F.R. § 154.93.

CONCLUSION

This case is complicated by the fact that both parties had anticipated that the decision in *Texaco* rendered by the United States Court of Appeals for the District of Columbia Circuit, which decision was that the indirect regulation or pricing method applicable to small producers was contrary to the Natural Gas Act, would likely be affirmed. So, the form of the opinion of the Supreme Court caught them by surprise in that it vacated the existing system and ordered the cause to be remanded to the Commission for the purpose of adopting regulations which were in accordance with the just and reasonable standard of the Act. But, the development which was even more of a surprise to not only the parties involved here but to all concerned was the almost immediate action of the Commission in supplanting area rates with national rates not only for the large producers but for the so-called small producers as well. Opinion No. 742-A provided that the small producer was entitled to a substantially higher rate than that which had been applicable to the large producer.

We are confronted, of course, with whether the contract before us, containing as it does a provision for a price of five years' duration and for renegotiation, continues in effect, or whether the Order No. 428 clause is an "area rate clause" within 18 C.F.R. § 154.93(b-1) so that Premier is entitled to the ceiling rate prescribed by the Commission in the 742-A opinion for small pro-

ducers. If this is true, the Order No. 428 clause renders the negotiated contract price obsolete.

Our conclusion is that the language in the FPC Order No. 428 clause contained in the contract in suit is plain in its terms and that the language therein that "the price charged for gas purchased and sold hereunder shall be such price as is permitted to be effective by the Federal Power Commission" is plain and unambiguous and does not vary materially from the area rate clause definition in FPC regulation 18 C.F.R. § 154.93 (b-1).

Oklahoma law language governs. *See Okla. Stat. Ann.* tit. 15 § 154 (West, 1966), which provides:

> The language of a contract is to govern its interpretation, if the language is clear and explicit, and does not involve an absurdity.

We reject the contention of Northern that this is a one-way street, which, although it does apply to pricing, the application is limited to lowering the price only — not to raising it. This position is at odds with the applicable language.

Accordingly, it is our conclusion that the judgment of the district court must be reversed and the cause must be remanded with directions to enter judgment for the plaintiff-appellant.

Small Producer Regulation) Docket No. R-393

OPINION NO. 742

OPINION AND ORDER AMENDING SECTION 157.40 OF THE REGULATIONS UNDER THE NATURAL GAS ACT

(Issued August 28, 1975)

SMITH, Commissioner:

Before Commissioners: John N. Nassikas, Chairman; William L. Springer, and Don S. Smith.

Syllabus

The Commission denies the request of several Members of Congress to cross-examine witnesses in a proceeding to establish a just and reasonable differential for small producer sales above the base rate applicable to large producers. Rulemaking procedures in rate cases do not present the need of a formal hearing with cross-examination.

The Commission certifies small producers to make small producer sales nation-wide at contract rates not in excess of 130 percent of the base ceiling rate applicable to comparable large producer sales. The higher overall rate of return for small producers is justified by their increased risks and higher financing costs. The Committee will monitor future small producer cost data.

The just and reasonable rate for small producers is to be determined by multiplying the 130 percent differential by the applicable base rate ceiling estab-

lished by the Commission in an area or national rate order. The rate is then subject to gathering charges, quality adjustments, tax reimbursement, Btu adjustments, and any other adjustment applicable to the sale and permitted or required under the pertinent order of general applicability.

The 130 percent differential for small producers does not apply to minimum rate levels established in certain area rate cases. However, an area rate clause in a small producer contract does provide authority for a small producer to collect a rate determined in accordance with the 130 percent differential.

An area rate clause in a resale contract provides authority for the processor to collect for the resale the rate charged by the small producer in accordance with the 130 percent differential.

A large producer which purchases gas from a small producer may resell the gas immediately upon the filing of its resale contract and certificate application. It need not await Commission action.

The Commission, on September 9, 1974, issued a Notice of Proposed Rulemaking in this proceeding (39 F.R. 33241, September 16, 1974) proposing to establish a just and reasonable rate differential for sales made by small producers pursuant to the blanket certificate procedure set forth in Order No. 428, 45 FPC 454, above the base rate (exclusive of provisions for production, severance, or similar tax reimbursement, gathering allowances, or quality adjustments) established for large producers in a Commission order of general applicability. The Commission explained in that Notice, pp.

3-6, the cost and non-cost considerations which in its tentative view supported the establishment of a differential for small producers.

Sixty-six initial comments and ten reply comments were received from sixty-eight companies, individuals, associations, and other groups. Large producers filed sixteen comments and two reply comments; small producers and producer associations filed twenty-seven comments and three reply comments; interstate pipelines filed twelve comments and one reply comment; gas distributors filed four comments and two reply comments; two consumer groups each filed an intial comment; and, federal officeholders filed five comments and two reply comments.

Certain Members of Congress requested the opportunity to cross-examine all witnesses upon which the Commission may rely in this case with respect to small producer costs.[1] In Opinion No. 699 issued June 21, 1974, in Docket No. R-389-B, mimeo pp. 9-14, we discussed at length the use of rule-making procedures in rate cases and the lack of need for a formal hearing with oral cross examination there. We adopt that discussion here, and based thereon, we deny the request for cross-examination.

The Public Service Commission of the State of New York (PSCNY) suggested that, in lieu of a percentage differential, we should establish a specific rate differential in cents per Mcf for small producers. PSCNY questions the need for giving small producers a multiple of

[1] Senator Abourezk, Representatives Addabbo, Ashley, Brown, Jr., Conyers, Jr., Dellums, Drinan, Harrington, Hechler, Holtzman, Kastenmeier, Lent, Moakley, Stark, Jr., Stokes, Sullivan, and Tiernan.

the base rate to the extent that base rate includes non-cost allowances for incentive or revenues for reinvestment. While non-cost factors, of course, are taken into consideration in determining the base rate in area or national rate cases, they are not always severable from cost factors. As the Commission indicated in Opinion No. 595, 45 FPC 674, 705, "we have not attempted the quantification of any non-cost factors, but rather have attempted to define cost in economic terms to include such considerations as the incentive necessary to elicit additional supplies of natural gas, competitive consequences upon the industry and the need for adequate capital to finance further exploration and development."[2] Moreover, contingent escalations, a non-cost incentive utilized in some area rate cases, are of little importance now in the light of our subsequent determination in Opinion No. 699, as amended, to establish a national new gas ceiling, in lieu of the various area ceilings previously in effect. One of the important advantages of the percentage approach is that it can be applied to each rate case of general applicability decided by the Commission in the past as well as in the future. While the percentage we determine here will not be necessarily a perpetually applicable determination, we do not intend to review it as often as the nationwide rate redeterminations. We conclude, therefore, that the percentage approach is more appropriate.

We pointed out in the September 9 notice (mimeo pp. 7-8) the difficulties involved in quantifying the differential in small producer and large producer costs. The difficulties are still apparent.

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[2] See also *Permian Area Rate Case*, 390 U.S. at 815.

The single most significant element in new gas costing is the productivity of successful wells in Mcf of reserves added per foot drilled. The productivity factor for small producers is probably lower than that for the larger producers. Small producers have relatively fewer offshore interests and the available evidence suggests that average offshore productivity is significantly higher than average onshore productivity. Further, in the onshore areas, small producers frequently operate properties on farm-out arrangements with the large producers. It is inevitable that the farmed-out properties are more marginal than average. Finally, small producers ordinarily do not have the resources to finance the deeper and much more expensive wells from which the larger remaining undiscovered reservoirs are to be found. The level of the productivity differential for small producers, however, is not quantified in the record.

Various studies also suggest that small producers are involved principally in exploratory, wildcat drilling and that a majority of the exploratory wells are drilled by small producers.[3] The ratio of allocated dry hole footage to successful gas well footage for the industry as a whole is approximately 1:1. That ratio is implicit in the dry hole allowance in the new gas costing methodology (Opinion 699). It is clear that the ratio is higher for the segment of the industry whose activity is weighted toward exploratory drilling. The fact could affect the small producer cost in two respects. First, it renders the small producer business more risky, a matter that will be considered in reference to the rate of return allowance. Second, the higher dry hole ratio could lead to an upward revision in the dry hole allowance. On

[3] See Comments, Office of Governor, State of Texas.

the other hand, the dry hole drilling costs per foot are significantly greater for the deeper wells and for the offshore. The small producers do little drilling offshore and the average producer well onshore is probably drilled to a depth less than the industry average. Thus, the impact of a higher ratio of dry holes may be partially or wholly offset by a lesser average cost per foot. The record does not provide the basis for conclusive judgment.

Other factors suggest a higher rate for small producers. The large companies produce most of the condensate, a fact that suggests that the net liquid credit for small producers should be less. The prominence of the farm-out arrangements in the small producer segment of the industry and the concomitant overriding royalty would support a higher royalty allowance for small producers. The small producers do not have the capital to finance the purchase and warehousing of large quantities of tubular goods and, consequently, must often pay higher prices for these items. Small producers that do not operate as drillers often must pay premium rates to the drilling contractor. But again, these increased cost elements are not quantified in the record and may be offset in whole or part by the fact that small producers incur less than average direct lease acquisition and other exploratory costs.

Exploratory and wildcat drilling is inherently more risky than developmental drilling. The small producers, consequently, have a higher risk factor than the large producers. The significance of that risk is enhanced by the limited risk-spreading capability and a relatively weaker credit standing of smaller enterprise. Risk assessment is a key factor in establishing a rate of re-

turn for regulated enterprise and we find that the small producers are entitled to a higher rate of return allowance than that applicable to the industry as a whole. The rate of return allowance in Opinion No. 699 was premised upon an assumed capital structure of 76% common equity and 24% long-term debt. The long-term debt was assigned a cost of 6.25% and the equity was allowed 17.73%. Most small producers are probably nearer to 100% equity financed and any supplemental debt financing undoubtedly is principally short-term and carries a substantially higher cost than 6.25%. While generally it is assumed that the equity investor's risk declines as the equity ratio is increased, the effect has a marginal range within which to operate, given the already high ratio assumed for the industry as a whole, and the effect is more than outweighed by the increased risk of the small producer ventures. We find that the combined risk increase, higher equity financing, and greater debt cost for small producers justifies an allowance for overall rate of return higher than the 15% that was found appropriate for the nationwide rate in Opinion No. 699.

We find also that a higher rate of return for small producers is justified as a means of encouraging new entrants in the industry. The number of producers in the oil and gas industry has declined dramatically in the past twenty years.[4] The resultant decline in exploratory capacity can be ill afforded concurrently with declining reserve additions.

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[4] The number of operating producers in the oil and gas industry has declined from approximately 12,000 in 1958 to about 5,600 in 1972, according to the Census of Mineral Industries.

An increased rate of return for small producers is amply justified; the level, however, is largely a matter of judgment. We find that at least a 20% rate of return is necessary to respond to the justifications.

Application of the Opinion No. 699-H DCF analysis with a 20% rate of return results in an increase of the high range rate of 51.46¢ to 67.67¢,[5] a 31.5% increase. Since producer ratemaking does not yield precise absolutes, an increment of 30% of the nationwide or other base rate would provide a proper allowance for small producers.

We find that the record thus far compiled does not provide an adequate statistical basis from which to quantify variances of the direct costs of small producers from the average direct costs for the industry that formed the basis for the Opinion No. 699 nationwide rate. While this proceeding will be closed with the issuance of this Order, the Commission will monitor any additional small producer cost data that may become available in the future. In the meantime, however, we find from the record evidence and applied judgment that the increased rate of return allowance for small producers is justified and that, therefore, the just and reasonable differential for small producers should be 130 percent.

In determining the just and reasonable rate for small producers, the 130% differential determined herein should be multiplied by the applicable base rate ceiling (e.g., flowing or new gas ceiling depending on sale involved) established by the Commission in an order of general applicability (e.g., an area or national rate or-

[5] See Appendix A.

der). The resulting rate would then be subject to gathering charges, quality adjustments, tax reimbursement, Btu adjustments, and any other adjustments, to the extent applicable to the sale and permitted or required under the particular order of general applicability involved. The total rate thus reached as a result of the 130% differential and the various adjustments thereto would be the just and reasonable rate for the small producer sale.

The 130% differential does not apply, as requested by TIPRO, to the minimum rate levels which have been established in certain area rate cases. We are not concerned here with contracts where the small producer is limited to a price below that authorized by this order as just and reasonable. Our purpose is to establish a just and reasonable rate ceiling, not a floor, for small producers.

The Commission finds that an area rate clause in a small producer contract does provide sufficient contractual authority for a small producer to collect a rate determined in accordance with the provisions of this order. We shall also amend Section 157.40(e) relating to the use of indefinite pricing provisions in small producer contracts so as to permit small producers to collect the just and reasonable rate determined here pursuant to such provisions. As we did in Order No. 455, 48 FPC 218, we shall provide that escalation clauses in existing contracts of those producers not holding small producer certificates shall not be triggered as a result of the action taken here with respect to small producer sales.

We agree with Tennessee that the price standards referred to in the September 9 Notice, mimeo p.9,

footnote 19, for determining whether a rate in excess of the rate established here is just and reasonable and, thus, includable in a pipeline's cost of service should be included in the regulations. This order will so provide. Such standards will apply to existing as well as new contracts involving small producers.

United Gas Pipe Line Company (United) contends that where a small producer is collecting a rate under an existing contract in excess of the just and reasonable rate, the small producer should be required under Section 5 of the Natural Gas Act to reduce its rate. Otherwise, United argues, the pipeline would be penalized *ad infinitum* for paying an above-ceiling rate. El Paso, on the other hand, contends that pipeline purchasers should not be required to absorb purchased gas costs with respect to above-ceiling purchases from small producers under existing contracts because the rules have changed since the issuance of Order No. 428. As we indicated in the September 9 Notice, mimeo p. 9, we do not intend to require small producers to make refunds of above-ceiling rates for sales made pursuant to temporary or permanent certificates under Order No. 428.[6] The Section 5 question, however, will be decided either in each individual pipeline case or in the rule-making proceeding in Docket No. RM76-5, relating to our proposal to require small producers prospectively to reduce their rates to the applicable just and reasonable ceiling established in this proceeding. The arguments advanced by El Paso should be taken into consideration in pipeline rate cases in determining whether to allow a pipeline to recover above-ceiling rates paid to small producers under existing contracts.

[6] See *F.P.C.* v. *Texaco, Inc., et al.*, 417 U.S. 380 (1974).

We reject the suggestion advanced by Pacific Gas Transmission Company that affiliates of pipelines be treated as small producers where applicable. The rationale underlying the treatment of small producers has no applicability to pipeline affiliates. See Order No. 308, 34 FPC 1202, 1203. Nor is there adequate merit to the suggestion of Mapco and Tricentrol that the 10 million Mcf cutoff between large and small producers be increased. We believe the 10 million Mcf cutoff figure is the most appropriate limitation. See Order No. 308, 34 FPC at 1202.

We also reject the contention of Bruce Anderson, *et al.*, that pipelines should be permitted to pay small producers (and include such payments in their cost of service rates) not only the just and reasonable rate determined herein, but also the rates as high as those authorized under Order Nos. 431 (limited-term certificate) and 455 (optional procedure). Rate determinations made under Order Nos. 431 and 455 are applicable only to the specific cases under consideration, and, thus, would have no general applicability to small producers. If small producers wish to seek treatment under those orders, they must apply therefor.

In view of the Court's ruling in *F.P.C.* v. *Texaco, Inc., et al.*, 417 U.S. 380 (1974), that it is proper to establish "one level of just and reasonable rates for small producers and another for large producers", there is no need to discuss the general allegations of undue discrimination advanced by certain large producers. The risk and operating differentials of small producers support the classification. They also claim, however, that our proposal will create royalty, joint leasing and state tax problems. But, these problems presumably have

been in existence for some time inasmuch as producers for years have been selling gas from the same stream at different prices. The effect, if any, of our action here on these problems is highly speculative at this juncture and depends on a variety of factors. In any event, this is not the appropriate case to resolve such matters. However, a producer may seek appropriate relief from this Commission if it is faced with a specific problem in this regard.

We do not believe, as some large producers have asserted, that small producers will acquire an unfair advantage with respect to the acquisition of leases because they may receive a higher rate for the sale of their gas. In light of the inherent advantages a large producer has over a small producer,[7] it is doubtful whether, except in isolated situations, this alleged advantage would make any significant difference in the acquisition of leases.

United and PSCNY have pointed out, quite properly, that Section 157.40(f) relating to filings by large producers with respect to the resale of gas purchased from small producers should be modified in accordance with *F.P.C.* v. *Texaco, Inc., supra,* and we shall so modify that section. In judging whether to suspend such a large producer filing, we will be guided by our determination here as to the just and reasonable rate for a small producer sale and the size of the differential between the purchase price from the small producer and the resale price by the large producer. If a proposed rate is suspended because the small producer price exceeds the just and reasonable rate established in this

[7] *Permian Basin Area Rate Cases,* 390 U.S. 747, 784-87.

case, then the same standards will apply in determining whether to allow a large producer to recover such costs as apply to similar pipeline purchases. And, if a proposed rate is suspended because of the differential between the purchase and resale price, we will determine the just and reasonable differential.

Contrary to Phillips' contention, the record in this case does not provide in our view an adequate basis for making a *Sierra* finding[8] which would authorize a processor who is an intermediate purchaser from a small producer to collect for the resale of such gas a rate in excess of its resale contract rate at a level that would permit the processor to recover the price paid to the small producer (up to the just and reasonable rate determined here) plus the customary differential between its purchase price and its resale price.[9]

We agree, however, with Gulf that where a processor has an area rate clause in its resale contract, such a clause provides sufficient contractual authority for the processor to collect for such resale the rate charged by the small producer as long as such rate does not exceed the just and reasonable rate authorized herein for small producers. But there is no basis in this record for allowing under such an area rate clause, as Skelly contends, a processor to file for the normal contract price differential between the purchase and resale price. The Commission lacks knowledge of what the normal differential is, let alone whether that differential is just and reasonable. However, if a producer has a contractual right to

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[8] *F.P.C.* v. *Sierra Pacific Power Co.*, 350 U.S. 348.

[9] Our refusal to make such a general finding does not preclude a large producer from seeking individual relief under *Sierra* if it can show entitlement thereto.

make a filing, we will at that time decide whether to accept or suspend the filing, and if it is suspended because of the differential between the purchase and resale price, we will then determine whether the differential is just and reasonable.

Phillips urges us to amend our regulations so as to allow the large producer who seeks to purchase gas from a small producer to commence deliveries immediately and then advise us of such action. In support thereof, Phillips claims that while a pipeline may negotiate a purchase contract with a small producer and accept deliveries immediately under budget type arrangements, a large producer before it can accept deliveries must (1) negotiate a new resale contract with its pipeline purchaser, (2) file the new contract, together with a certificate application to resell such gas, and (3) await Commission action with respect to such application.

In Order No. 428-B, 46 FPC 47, 48, we eased the requirements relating to certificate applications so that a large producer could commence its sale immediately upon the filing of a certificate application when reselling gas purchased from a small producer.[10] Consequently, contrary to Phillips' third point, there is no need for a large producer to await Commission action. Moreover, even under Phillips' proposal, a large producer would still have to negotiate a new resale contract. There, thus, is no merit to its first point. The only point of any substance to which Phillips has alluded is that a large producer is required to file its resale contract and certificate application. Such a requirement, we think, is

[10] See Section 157.40(h).

plainly reasonable. We, therefore, decline to amend the regulations in the manner requested by Phillips.

We also decline to increase the interests of large producers which may be covered by a small producer certificate under Section 157.40(a) (3) from 12½ percent to 50 percent, as requested by Cabot. Adequate justification has not been shown for taking such action.

The Commission finds:

(1) The notice and opportunity to participate in this rulemaking proceeding through the submission, in writing, of data, views, comments, and suggestions are in accordance with all procedural requirements therefor as prescribed in Section 553, Title 5 of the Uited States Code.

(2) The action taken herein is necessary and appropriate for the administration of the Natural Gas Act.

(3) Since the additional amendments to Section 157.40 of the Commission's Regulations Under the Natural Gas Act prescribed herein are consistent with the prime purpose of the proposed rulemaking, further notice thereof is unnecssary.

(4) In view of the purpose, intent, and effect of the amendments herein ordered, good cause exists for making the amendments effective upon issuance of this order.

The Commission, acting pursuant to the provisions of the Natural Gas Act, as amended, particularly Sections 4, 5, 7, and 16 (52 Stat. 822, 823, 824, 825, and

830; 56 Stat. 83, 84; 61 Stat. 459; 76 Stat. 72; 15 U.S.C. 717c, 717d, 717f, and 717o), *orders:*

(A) Section 157.40 in Part 157, Subchapter E, of Chapter I, Title 18 of the Code of Federal Regulations is amended by revising subparagraphs (c), (e), and (f), and by adding subparagraph (i) to read as follows:

§157.40 Exemption of small producers from certain filing requirements.

* * * * *

(c) *Rate and Certificate Regulation under blanket certificate.* Small producers certificated hereunder shall be authorized to make small producer sales nationwide pursuant to existing and future contracts at the price specified in each such contract. If the contractually authorized rate does not exceed 130 percent of the Commission-determined base ceiling rate applicable to a comparable large producer sale, subject to any adjustments permitted or required under the particular order of general applicability involved, the rate may be charged and received by the small producer and paid by the purchaser, as the lawful, just and reasonable rate approved by the Commission pursuant to Sections 4, 5, and 7 of the Act. However, no small producer shall be relieved from compliance with Section 7(b) of the Natural Gas Act with respect to any small producer sale regulated hereunder. Rate regulation as prescribed herein shall not apply to any jurisdictional sales made by a small producer where the gas reserves relating thereto were acquired by the purchase of developed reserves in place from a large producer. Nothing done hereunder shall be recognized by the Commission as triggering any escalation clause in an existing contract involving a producer not covered by a small producer

certificate, except as provided in subparagraph (f) of this section.

* * * * *

(e) *Limitation on contractual provisions.* No Small Producer granted exemption under subparagraph (c) above shall charge or collect any rate for a small producer sale of natural gas in excess of the just and reasonable rate prescribed in that paragraph, where the contractual right to such rate is based upon any contractual provision which would not be permitted by subsections (a), (b), (b-1), and (c) of Section 154.93. For the purpose of this limitation, it shall make no difference whether the contract was executed prior to or subsequent to April 3, 1962.

(f) *Filings by large producers with respect to related resales.* A large producer may file for the price specified in its related contract for the resale of any natural gas sold to it by a small producer pursuant to the exemption authorized hereunder. In determining whether to accept or suspend such a filing, we shall be guided by the just and reasonable rate for small producers established in subparagraph (c) above and the size of the differential between the purchase and resale price. In the event the proposed rate is suspended because of the rate level paid to a small producer, the same standards set forth in subparagraph (i) below with respect to pipeline purchases shall apply to the purchase by the large producer. A large producer under an area rate clause in its resale contract may file for the rate paid by it for gas purchased from a small producer as long as the rate does not exceed the just and reasonable rate prescribed in subparagraph (c) above.

* * * * *

(i) *Pipeline purchases.* If a pipeline company purchases gas from a producer who is selling such gas pursuant to a small producer certificate at a rate in excess of the just and reasonable rate established in subparagraph (c) above, then the pipeline purchaser must show that the rate paid to the small producer is just and reasonable before it may include any amount in excess of the just and reasonable rate in subparagraph (c) above in its cost of service. In determining whether the small producer's rate is just and reasonable in such a situation, the Commission will consider all relevant factors including (1) producer's costs, (2) the pipeline's need for gas, (3) the availability of other gas supplies, (4) the amount of gas dedicated under the contract, (5) the rates of other recent small producer sales previously approved for flow through and (6) comparison with appropriate market prices.

(B) The amendments adopted herein shall be effective upon issuance of this order.

(C) The Secretary of the Commission shall cause prompt publication of this order to be made in the Federal Register.

NASSIKAS, Chairman, *dissenting:*

It is with great reluctance that I dissent to the majority order in this proceeding. I do so only because I am convinced that the order as drafted will not encourage "small producers" to dedicate additional gas supplies to the interstate market and that there is a dearth of "substantial evidence" supporting the majority order. Moreover, the order will end the concept of indirect regulation of "small producers" for which

the Commission only recently gained judicial approval. *FPC* v. *Texaco Inc.*, 417 U.S. 380 (1974).

The just and reasonable differential prescribed by the majority order is not supported by "substantial evidence" and will not pass judicial review.[1] The differential is based solely upon the assertion that small producers should be allowed a twenty (20) percent rate of return. This, in turn, is based on the analysis of the capital structure of a number of large petroleum companies which demonstrated that the 15 percent overall rate of return allowed in the national rate case yields a 17.73 percent rate of return on common equity.[2] There is no evidence in this record which indicates the capital structure of the typical small producer or the level risks incurred by small producers versus the level of risks for large producers.[3]

In Opinion Nos. 699 and 699-H, the Commission established the concept of a total rate design including provisions providing for the granting of relief from op-

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[1] To be affirmed, Commission orders must be supported by "substantial evidence." Natural Gas Act, § 19(b); 52 Stat. 831 (1938); 15 U.S.C. §717r(b)(1970).

[2] *Just And Reasonable National Rates For Sales Of Natural Gas From Wells Commenced On Or After January 1, 1973, And New Dedications Of Natural Gas To Interstate Commerce On Or After January 1, 1973*, Opinion No. 699-H at 32-33, ... F.P.C. ....., ...-..... (1974) (hereinafter "*Just and Reasonable New Gas Rates*").

[3] Those small producers responding to the notice of proposed rulemaking simply paraphrased the Commission's comments regarding the risks incurred by the small producer as compared to the large producer without attempting to quantify in any meaningful fashion the criteria which allegedly support this argument.

pressive rates in appropriate circumstances.[4] The fundamental principle expressed in those opinions was the adoption of "'a total rate structure [designed] to motivate private producers to fully develop [the nation's natural gas] resources' while assuring the consumer an adequate supply of gas at a reasonable rate."[5] We specifically considered the need for additional capital generation in the industry[6] and the impact of the rate established on the consumer.[7] The foundation was "a uniform national rate . . . [to provide] the incentives to stimulate and encourage the unprecedented exploration and development efforts that will be necessary to find and produce the requisite level of new natural gas supplies."[8]

If small producers are, in fact, incurring higher costs, they have available to them the optional procedure[9]

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[4] Opinion No. 699-H at 73-74, ... F.P.C. ....., ...-.....

[5] *Id.* citing *Placid Oil Co.* v. *FPC*, 483 F.2d 880, 891 (5th Cir., 1973) *affirmed sub nom. Mobil Oil Corp.* v. *FPC*, 417 U.S. 283 (1974) (note omitted). See also, Opinion No. 699 at 23-24, ... F.P.C. ....., ...-.....

[6] Opinion No. 699 at 23-24, 115-118, ... F.P.C. ....., ...-....., ...-.....; Opinion No. 699-H at 53-54, ... F.P.C. ....., ...-.....

[7] Opinion No. 699-H at 54-59, ... F.P.C. ....., ...-.....

[8] Opinion No. 699-H at 24, ... F.P.C. ....., ...-.....

[9] 18 C.F.R. §2.75; *Optional Procedure For Certificating New Producer Sales Of Natural Gas*, Docket No. 441, Order No. 455, 48 F.P.C. 218 (1972), amended, Order No. 455-A, 48 F.P.C. 477 (1972), *affirmed sub nom. John E. Moss, et al.* v. *FPC*, 402 F.2d 461 (D.C. Cir., 1974) (reversed as to pregranted abandonment), *cert. granted* on limited issue of pregranted abandonment, No. 74-885 (June 16, 1975). Regulations amended, Order No. 455-B, ... F.P.C. ..... (November 25, 1974).

and special relief procedures.[10] Moreover, the optional procedure was precisely designed to establish just and reasonable rates on a cost of the project basis.[11] Small producers can also file group petitions for special relief where it would not be economically feasible for such small producers to file such petitions on an individual basis.[12]

The establishment of a differential is repugnant to the concept expressed in the national rate opinions that the base rates should be uniform except in those cases where the seller can demonstrate that the individual circumstances require a different result. I would, therefore, permit small producers (whether on an individual or group basis) to demonstrate that their circumstances are truly unique and require a departure from the uniform national rate. It may well be that in many cases the pipeline's need for additional gas supplies to increase deliveries and reduce curtailments and unit transportation costs will override the need for intract-

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[10] 18 C.F.R. §2.76, *Policy With Respect To Sales Where Reduced Pressures, Need For Reconditioning, Deeper Drilling Or Other Factors Making Further Production Uneconomical At Existing Prices*, 49 F.P.C. 992, amended, 49 F.P.C. 1325 (1973); 18 C.F.R. §2.77, *Flaring And Venting Of Natural Gas*, 49 F.P.C. 996, *rehearing denied*, 49 F.P.C. 1324 (1973). Also, special relief provisions are an integral part of the area rate opinions (*e.g., Area Rate Proceeding* (*Southern Louisiana Area*), 46 F.P.C. 86, 144-145 (1971) and the national rate opinion (*Just And Reasonable New Gas Rates*, Opinion No. 699-H at 82-83, ... F.P.C. ....., ...-..... (1974)).

[11] *Texas Eastern Exploration Company*, Docket No. CI74-530, ... F.P.C. ..... (May 15, 1974); see also, *William A. Jenkins (Operator), et al.*, Docket Nos. CI75-119 and RI75-5, ... F.P.C. ..... (October 3, 1974).

[12] *Independent Oil & Gas Association of West Virginia* v. *Consolidated Gas Supply Corporation, et al.*, Docket No. RI74-188; *Independent Oil & Gas Association of West Virginia*, Docket No. RI75-21.

able profit controls over small producer sales such that relief from the generally applicable rates will be warranted.

If, as the majority order purports to do, small producer rates are to be established on the basis of alleged cost factors, the concept of indirect regulation at the pipeline level to prescribe just and reasonable rates for small producers is no longer applicable since a just and reasonable rate will have been established at the small producer level. I would continue the indirect regulation of small producer rates at the pipeline level by reviewing all small producer rates in excess of the generally applicable just and reasonable rate[13] to determine the rates which the pipelines were justified in paying by applying the criteria which the Commission informed the Supreme Court would be utilized in prescribing small producer rates:

> The Commission, in its brief, has indicated that the standard will not be limited to comparisons with appropriate market prices, but will include (1) producer's costs, (2) the pipeline's need for gas, (3) the availability of other gas supplies, (4) the amount of gas dedicated under the contract, and (5) the rates of other recent small-producer sales previously approved for flow-through.[14]

These criteria provide greater flexibility than the unwarranted differential proposed by the majority, and they will allow the Commission to adapt its regulation to prescribe rates based on *an evidentiary* record without excessive charges to consumers.

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[13] The generally applicable rates are the area rates for pre-1973 sales and for post-1972 sales the national rate prescribed in Opinion No. 699-H, *Just And Reasonable New Gas Rates.*

[14] *FPC* v. *Texaco Inc.*, 417 U.S. 380, 397, n. 7 (1974).

The dividing line between large and small producers originally adopted for classification purposes to reduce the administrative burden on small producers[15] has now been distorted into a classification system to determine whether certain persons will or will not receive higher rates. I simply do not believe that a distinction can be made between the risks faced by a small producer selling less than 10,000,000 Mcf per year in interstate commerce and the risks of a small producer selling 10,000,001 Mcf per year or above.

Finally, the establishment of a differential will undermine the Commission's actions to encourage all producers to sell their available gas supplies to the interstate market since it will tend to induce both large and small producers to sell their newly discovered gas reserves to the intrastate markets. The large producer will sell in the intrastate market in order to obtain the higher prices prevailing there. The small producer will sell additional gas supplies to the intrastate market in order to stay below the 10 Bcf annual sales limitation and to obtain the higher prices in the intrastate market. Because the proposed 30 percent differential will not equate to the going intrastate prices, the intrastate consumer will be effectively deprived of any new onshore supplies of natural gas as a result of the majority order.

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[15] The small producer classification was first adopted in the original Permian proceeding, *Area Rate Proceeding (Permian Basin Area)*, 34 F.P.C. 159, 234-236 (1965), to encourage small producers to dedicate new supplies of natural gas to the interstate market.

Appendix A

COMPUTATION OF RETURN ON INVESTMENT AND ROYALTY

(Computations for Trended Data @ 20% Rate of Return)

Component	Year	Value	Tax Credit	Net Investment (Value less Tax Credit)	Present Value (Time = 0.5) [1]
Other Exploration	−3	2.80	1.2770	1.523	2.6317
Exploration Overhead	−3	0.83	0.3739	0.446	0.7707
Lease Acquisition	−2	4.28	a	4.28	6.1632
Dry Holes	−1	3.72	1.786	1.934	2.3213
Successful Well & Recompletions	−1	6.35	2.134	4.216	5.0592
Other Production Facilities	−1	1.39	0	1.39	1.6680
Lease Acquisition Tax Credit	−1		1.540	−1.540	−1.8480
Total		19.36	7.1109		16.7661

[a] The lease acquisition tax credit is taken in year −1.

[1] Net Investment times applicable compound discount factor at 20% (Time = 0.5).

Note: All calculations in this appendix are based on methodology in Commission Opinion No. 699-H, issued December 4, 1974, Appendix C, Sheets 6 and 7.

COMPUTATION OF RETURN ON INVESTMENT AND ROYALTY

(Computations for Trended Data @ 20% Rate of Return)

Computation of Net Cash Flow

Price	X
- Royalty	-0.16X
- Operating Expense	-3.10
- Interest on Working Capital	-1.67
- Regulatory Expense	-0.20
- Tax Liability to offset Tax Credit	-7.1109
+ Net Liquid Credit	+3.89
Total	0.84X - 8.1909

At the midpoint of the first production year the present value of the net cash flow plus the present value of the 1.0 cents per Mcf annual escalation must equal the present value of the net investment.

From Opinion No. 699 (Appendix H, Case II and Case III)

$$16.7661 = ((0.84X - 8.1909) \times (1/18) \times 5.774635)^{1} + ((0.84/18) \times 24.816566)^{2}$$

$$X = 67.67¢/Mcf$$

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[1] Calculation of present worth for net cash flow over next 17 years — formula [1] P. 3 of Appendix H, Opinion No. 699, expressed at 20%.

[2] $$\sum_{o}^{17} \left(\frac{1}{1.20}\right)^{i} = \frac{1.20 - \left(\frac{1}{1.20}\right)^{17}}{0.20} = 5.774635$$

Year	Discount Factor @ 20%	Discounted Net Cash Flow
(a)	(b)	(a) × (b)
1	0.833333	0.833333
2	0.694444	1.388888

MARCH TERM — April 18, 1980

Before Honorable William E. Doyle, Honorable Jean S. Breitenstein and Honorable Monroe G. McKay, Circuit Judges

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No. 78-2014

PREMIER RESOURCES, LTD.,
a corporation,
Plaintiff-Appellant,

vs.

NORTHERN NATURAL GAS COMPANY
Defendant-Appellee.

This matter comes on for consideration of appellee's motion for recall and stay of mandate pending application for certiorari in the captioned case. The Court also has for consideration the appellant's response to the motion for stay.

Upon consideration whereof, it is ordered that the mandate of this Court issued March 26, 1980, is hereby recalled.

It is further ordered that the mandate shall be stayed until May 8, 1980, pending certiorari, and that if, on or before that date, there is filed with the Clerk of the Court of Appeals a notice from the Clerk of the Supreme Court of the United States that appellee has timely filed a petition for writ of certiorari in the Supreme Court, the stay shall continue until final disposition by the Supreme Court.

/s/ HOWARD K. PHILLIPS
HOWARD K. PHILLIPS, *Clerk*

IN THE
UNITED STATES DISTRICT COURT
FOR THE WESTERN DISTRICT
OF OKLAHOMA

Case No. CIV-78-0201-E

PREMIER RESOURCES, LTD.,
a corporation,

Plaintiff,

vs.

NORTHERN NATURAL GAS CO.,
a corporation,

Defendant.

**EXCERPT FROM TRANSCRIPT OF TRIAL
HAD ON NOVEMBER 16 & 17, 1978
BEFORE THE HONORABLE
LUTHER B. EUBANKS
DISTRICT JUDGE PRESIDING**

* * * * *

THE COURT: Now Mr. Kenan, I don't believe I need to hear any argument from you. I wanted to hear the Plaintiff to be sure that I hadn't overlooked anything. But, they have advanced. I may observe here, and I think it goes uncontradicted that Plaintiff's counsel has been very able in this case, ably represented their client, and very forcefully so. But, the facts are just not on your side. They are just not. I think I can

demonstrate why I know to my complete satisfaction and I want to say to Mr. Birke, this price can go up. This indeed is a two edged sword in this contract. But, what we have got to stop and recognize is — and this is really not disputed here — there are just two formulas or methods of price determination in the industry. One is the area rate clause, and that is not our case because the area rate clause is just not here. I will say why in a moment. The other is the redetermination or renegotiation proviso, which it is undisputed here under the law, can not be redetermined more often than once every five years excepting only after their initial discovery and the first redetermination can be after three years. Now, that is the way that I understand both sides interpret this Section 154.93 of the F.P.C. Regulations, and that is mentioned in Article V of the contract.

Now, that is the one we have here. I say that you can not renegotiate or redetermine more often than the contract says, because the Federal Power Commission has said you can not do it more often. And, that is the reason it is written in the contract like it is. Now, why didn't you have the area rate determination clause in this? It is clear. If you had, you were also going to get 26 cents less per Mcf for this gas than you got under this contract. This was indeed the most favorable contract that was in town. It was the best deal in town for these Plaintiffs at the time it was signed. Although it was not clear what the Courts would do with respect to F.P.C. Order Number 428, the parties then knew that that order had been rescinded by the Court of Appeals for the District of Columbia. That being so, the highest legal rate that could be paid there was 20

cents rather than 46 cents, but the Plaintiffs were willing to take the higher rate and agreed that if the Court later affirmed that order — that is the order of the Court of Appeals to the District of Columbia is affirmed, we will pay back, because we know we are getting more than the law allows now. But, notwithstanding, these Defendants did promise, and I find it a fact they said, "We are going to always have a competitive rate and in effect we are going to pay as much as the law allows." And, I think that was a promise. But, it was not a promise that this thing was going to be renegotiated every month or every year. It meant that the very highest price available is going to be paid for the initial period and the same is always going to be determined on any renewal period. Whatever the then existing highest possible legal rate is, we are going to put it in the contract. And, then that rate will hold for the five years until it is renegotiated.

Of course, the parties at the time the contract was negotiated were looking to price change as a result of court action, and not because of the pressure of market conditions. I think everybody probably thought that the price is going to go up as far as the open market is concerned if we are free to deal. But, as long as gas is regulated, that confounded Federal Power Commission is not going to let us get a fair price for this gas, and therefore, the only way to go is down, because the Federal Power Commission has established a lower rate for the big producers.

Now, gentlemen, let me say this: That these negotiators for the Plaintiff were not neophytes. They were sophisticated and educated and highly competent people. You had Mr. Harnden, who is a CPA and a very

abled person, and Malcolm Crawford, a very able lawyer, and his late lament that "I am not an expert in oil and gas law" really does not have a great deal of weight with this Court, because it is demonstrated here by the Defendant's Exhibit Number 24 that almost the identical pricing proviso was adopted by Mr. Crawford in this prospectus for the Securities and Exchange Commission as is contained in these contract documents, Plaintiff's 1, 2, 3 and other. I think he is such an able lawyer, and I find he is a fine lawyer, that he is not about to blindly adopt something that he knows nothing about. He knew about it. He is just more knowledgeable in the area than he is now willing to admit, and I think he spoke the truth when he said they told him they were going to give him the highest price available. I made a note here. Mr. Crawford said he understood during the negotiations at all times that this contract was for some fixed period of time as required by the Federal Power Commission. So, he realized there was going to be an initial period of time where the price was going to be fixed. It started at 46 cents, which is the highest it could be. So, really, when you get down to it, there is not a great deal of dispute in the evidence here. Now, finally, the Court finds that this contract is to some extent uncertain and indefinite. So, I am going to now hold that all the parol evidence that the Court has heard is indeed proper and admissible evidence as tended to explain the slight ambiguity in the contract. I at the same time say that if the Court had the facts in my mind in advance, I would not have permitted testimony concerning the negotiations that led up to the signing of the contract, because negotiations are deemed to be merged into the written contract. But, it makes no real difference here because I find that

the negotiations and the finished product are not substantially different. It is just the interpretation that parties now place on them after having hindsight to view. Now, we have all got 20/20 vision hindsight. But, back there when they were negotiating this contract, the foresight was a little blurred and dimmed and not nearly as good as when we look back on it.

I find, as a matter of fact, that the primary purpose — and that may be a little bit elusive term — but, the primary purpose of the Denver meeting was to discuss this money advance, the financing prcblem, and to incorporate a unique feature whereby you have got both an advancement of the drilling costs, which could be converted into prepayments and refunded or paid back over the long period of time after giving some data as to the potential of the well, the reserve, and the life expectancy and that that consumed most of the time, although price was discussed. And, it was just simply stated, 46 cents is the highest we believe that the Federal Power Commission will approve insofar as a determination thus being prudent purchasers, understanding that there is no ceiling on price the small producers could sell for. But, a purchaser was governed by that prudent purchase rule that would not permit it to say, "The sky is the limit." The Defendant felt that 46 cents is about as high as they could go, and Plaintiff did not argue with that since it is over doubled the going rate that the large producers were getting. So, this financing thing did indeed occupy most of the time. And, negotiators for the Plaintiff here, particularly the CPA and the lawyer, fully understood what the pricing scheme was going to be. They were knowledgeable in the area, maybe not experts to the point that the De-

fendant people were, particularly Mr. Poehling and others. But, at least they were knowledgeable. They had dealt with this before. They had this Seiger No. 1 contract, which is identical. And, apparently they liked it and lived with it, and were willing to sign new contracts under substantially identical terms.

Now, gentlemen, the issues are all found in favor of the Defendant and against the Plaintiff. If counsel now, on either side, know of any findings that the Court should make that it has not made, let's let it be known now. Do the Defendants know of any finding, any contested issue here, factual issue that the Court has not ruled upon?

MR. KENAN: No, your Honor.

THE COURT: How about Plaintiffs?

MR. BIRKE: Your Honor, I am a little unclear about certain aspects of the Court's ruling. Do I understand the Court to be saying that it finds that as a matter of law, as a result of this Regulation 154 — I am not sure of the other numbers — that it would be impermissible for the price to go up as in accordance with the Plaintiff's contentions?

THE COURT: No, I didn't say that at all. I say, if you have an area rate clause in there, of course you can go up. But, absent a rate clause and falling back on this one that was in this contract, the redetermination-renegotiation clause, that under that regulation you can not redetermine oftener than five years, except the evidence here is the first time you can — that is, that was the law that the parties were under at the time this contract was adopted.

MR. BIRKE: For clarification, your Honor —

THE COURT: Yes, Sir.

MR. BIRKE: Is the Court saying that as a result of the fact that this contract has a redetermination clause in it, that at this present time under the existing regulation, it will be illegal under F.P.C. regulations for the Court to award us the higher price? I am speaking of the present.

THE COURT: Well, I don't know. Now, I don't have to rule on that. I say that this contract that is before me has a renegotiation clause in it and the price to be renegotiated at the end of the five-year period, and that is when it will occur and not sooner. That was in keeping with what the law required at the time. That is the testimony of Mr. Poehling.

MR. BIRKE: Well, I am just trying to understand the relationship of the Court's finding to the language in 154. Is the Court saying that as a result of the existence of 154 at the time the contract was signed, as applied to the facts as they subsequently occurred, that it is illegal now for the Court to rule that the price goes up?

THE COURT: No, I am not about to say it is illegal for the price to go up at all. I am saying that the parties made a contract here that they must adhere to and among other things, the Plaintiffs had apparently a choice of taking the area rate of 20 cents per MCF or rolling the dice and double the rate, 46 cents per MCF, with possibility it may be cut back if the Court affirmed, the Supreme Court affirmed the then existing order. And, they took the highest price and that it can not be absent an agreement to adhere to the fixed rate — that is for large producers, the highest rate absent

an agreement be bound by it, You can not take a higher rate and then renegotiate it oftener than the five years. And, that is the undisputed testimony in this case, except for the initial period it could be renegotiated after three years.

MR. BIRKE: I would ask the Court if it would please make a Finding as to whether or not Order Number 428, as modified as it existed at the time the contracts were signed — I want to use the exact language of the contract.

THE COURT: Go ahead.

MR. BIRKE: I repeat, if I may, your Honor, I would like the Court to please make a Finding whether F.P.C. Order Number 428, as modified, as it existed at the date the contracts were signed, is now effective or not effective with respect to the sale of the gas under these contracts.

THE COURT: Well, I am not going to second guess the Supreme Court of the United States, counsel. I am going to say at the time these contracts were signed, it was at that time held to be invalid. But, the Supreme Court later reversed that and said that it is not invalid, I suppose under the Equal Protection Clause. But, it is so vague and ambiguous that it ought to be redone. Apparently that is what the Supreme Court says.

MR. BIRKE: Well, first, the Court said he wanted to make a Finding —

THE COURT: I am not going to make a Finding as to what the Supreme Court of the United States did. The Opinion speaks for itself.

MR. BIRKE: All right. I hope the Court won't think I am pushing. Just really, in my own mind, I don't know whether it is this Court's belief or finding or opinion that 428, as existed at that time, is now effective with respect to the — is now effective with respect to the sale of gas under the contracts.

THE COURT: Well, I don't think it is material to the issues here, but I say that this contract, counsel, when it becomes subject to renegotiation, allows your client to get the very highest price that the industry can legally offer, irrespective of 428 or whatever, because 428 apparently was held to the Supreme Court to be no impediment at all to a small producer getting a greater amount that the area rate for a large producer.

MR. BIRKE: Thank you. I do not wish the Court to think I am satisfied with that.

THE COURT: I don't expect you to be satisfied. You wouldn't be here if you were satisfied with the Court's ruling, but I have no difficulty in finding as I have. I think it is clear you just can not make a different situation out of it, counsel.

MR. BIRKE: We would ask for Formal Findings of Fact and Conclusions of Law.

THE COURT: They have been made and they are dictated into the record and you can order a copy of them from the court reporter. Anything further? All right. Now, I will ask that counsel for the Defendant prepare a Formal Judgment in accordance with this, and get it approved as to form by counsel for the Plaintiff and bring it into me for signature and filing at your earliest convenience. The Court will be in recess.